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SUBJECT: Spending Sprees And Tax Hikes: The Highs And Lows Of The
UK Pre-Budget Report

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11. (SBU) Summary: The November 24 2008 UK Pre-budget report (PBR) announces a GBP 20 billion stimulus package and deficit financing to respond to the recession brought on the global financial crisis. Government debt will double to GBP 1 trillion over the next few years before declining, and the budget will not be in balance again until 2016. The PBR projects the stimulus will add approximately 0.5 percent to the previously forecast negative growth for 2009 of -1.5 percent. The stimulus package includes a 2.5 percent reduction in the Value Added Tax (VAT), advancing infrastructure projects, and spending to help individuals and companies most affected by the economic downturn. The package will be paid for by future tax increases, including a 0.5 percent increase in the National Insurance levee. In addition, it includes a new upper tax bracket of 45 percent for the wealthy, signaling a return to income redistribution and an end to the "New Labour" policy not to increase the maximum tax rate. Politically, the PBR evidences Prime Minister Brown's transformation in the eyes of the public from an indecisive risk-averse ditherer who couldn't prevent a run on the Northern Rock bank to a decisive innovative thinker, willing to take bold action and lead the world's developed economies by example. Brown's turnaround in the polls, narrowing the Tory lead to single digits, is largely due to his emergence over the last few months as a leader in responding to the financial crisis. End Summary.

Background: PM Brown On The International Stage

12. (U) The first UK victim of the global financial crisis was the mortgage lender Northern Rock (NR). It sought funding from the Bank of England in the fall of 2007 as wholesale credit markets seized up. A run on the bank led ultimately to the government nationalizing NR in February. The government's handling of the NR crisis evoked widespread criticism of both Prime Minister Brown and Chancellor Darling. Their dithering was said to have made the NR crisis worse and was consistent with Brown's reputation for being highly risk averse and not wanting to make tough decisions. The dithering moniker contributed significantly to Brown's declining poll data through the first half of 2008. As the financial crisis worsened, Brown reversed his political fortunes by positioning himself and his government to appear as leaders in developing a global consensus on responding to the crisis and reforming the structure of the world's financial system. At the G-7 meeting in Paris, Brown argued for aggressive coordinated monetary policy action among central banks and significant fiscal stimuli. Brown continued these themes at the November G-20 meeting. His aggressive handling of the UK response to the deepening global financial crisis not only reversed his declining poll numbers but has narrowed the Tory lead to single digits. The 2008 PBR certainly reflects Brown's newly adopted preference for taking bold action.

Strategy: A Fiscal Stimulus Package

13. (U) To respond to global financial challenges, the PBR proposes a large immediate fiscal stimulus package plus borrowing to offset declining government revenue. Without referencing Brown's "golden rule" that the government should only borrow to invest rather than to finance expenditure, and his "sustainable investment rule" that government borrowing should not exceed 40 percent of GDP, the PBR abandons them completely. The objective is to keep people employed, restore consumer confidence, and get them spending again. According to the PBR, the economy will turn around in the second half of 2009.

Future taxes and a recovering economy will pay for the program. Significantly, the government signaled it was abandoning a key tenet of Tony Blair's "New Labour" and returning to Labour's traditional philosophy of income redistribution by announcing a new higher tax bracket on the wealthy.

The Key Elements

14. (U) The largest part of the Chancellor's GBP 20 billion fiscal stimulus package is a value-added tax rate cut of 2.5 percent to 15 percent from December 1, 2008 to December 31, 2009. This will ease the annual tax burden by GBP 12.4 billion. A number of public infrastructure projects, totaling GBP 3 billion, are being brought forward to support jobs during the slump. Increasing personal tax allowances will ease the tax burden a further GBP 3.6 billion, corporate tax measures will ease the burden on businesses by GBP 500 million and delaying higher vehicle excise duty rates for more polluting cars will ease the burden by GBP 500 million.

The Impact On Growth: Government Projections

15. (U) The Chancellor told MPs that the measures adopted were designed to limit the length and depth of the recession. HM

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Treasury forecasts a short, shallow downturn with output recovering quickly by mid-2009. It forecasts GDP growth of 0.8 percent in 2008, between -0.75 percent and -1.25 percent in 2009, and positive growth of between 1.5 percent and 2 percent in 2010. These projections represent a marked change from those in the March Budget. In March, Darling estimated growth of about 2 percent for this year and 2.5 percent in 2009. These forecasts were based on the belief that the credit crunch would ease in the second half of this year and that financial market conditions would return to normal by 2009. Despite these substantial downgrades, Darling's projections are still more optimistic than many independent forecasts, particularly with regard the timing of a recovery.

Implications For Government Finance

16. (U) An economic slowdown, combined with a GBP 20 billion stimulus package, will have a dramatic impact on the state of public finances. The tough economic climate has significantly reduced tax revenue, with receipts from the financial sector alone expected to fall by 35 percent this year. This will result in higher borrowing levels - with forecasts of GBP 78 billion this year and GBP 118 billion in 2009, or 8 percent of GDP. UK net debt, as a share of GDP, will increase from 41 percent this year, to 48 percent in 2009/2010 and will peak at 57 percent in 2014. If these fiscal projections are accurate, the budget will not balance until 2015/2016.

The Next Challenge: Repayment

17. (U) The record borrowing levels will be paid for via a tightening fiscal policy from 2011 (notably, this will occur after the next general election which must be held no later than 2010). National insurance contributions will increase for both employers and employees and a new 45 percent tax bracket will be introduced for those earning more than GBP 150,000 annually. The Chancellor also announced increased government efficiency savings of GBP 5 billion in 2010/2011.

Policy Implications

18. (U) Environmental: The Chancellor said he is determined that the present economic uncertainty should not undermine the priority of protecting the environment. During his statement in the House of Commons, Darling announced that he has scrapped plans for a per-plane tax (introduced in the 2007 PBR) to replace air passenger duty (APD), despite cross-party support for the aircraft tax. Instead, a four-band APD will be introduced so those flying the furthest will pay the most. The reformed APD will be implemented from November 1 2009, moving from two to four distance bands to improve environmental signals. The policy u-turn was made, according to the Chancellor, in order to ensure greater stability and to protect competitiveness at a time of economic uncertainty, while also reducing emissions from aviation. The PBR extends the Renewables Obligation for an additional ten years, to 2037. (Note: The Renewables Obligation was developed as an incentive to encourage new renewables generation by placing a mandatory requirement for UK electricity suppliers to source a growing percentage of electricity from eligible renewable generation capacity. End note.) The Chancellor reconfirmed the UK's commitment to meeting its Kyoto targets, to legislation that sets binding commitments to cut emissions through the Climate Change Bill, and to the EU Emissions Trading Scheme.

19. (U) Business: The PBR included measures to improve business access to credit and to ease cash flow problems. The Chancellor announced that foreign dividends received by large and medium groups on ordinary shares and most non-ordinary shares will be exempt from UK tax. Small businesses facing difficulties will be able to spread their payable tax over an affordable timetable. HMG has also agreed a GBP 4 billion deal with the European Investment Bank to provide money to banks to pass on to SMEs. HMG will offer credit through a temporary Small Business Finance Scheme, allowing small businesses to borrow up to a million pounds on flexible terms. The Chancellor decided to defer the increase in the small companies rate of corporation tax. The total package of measures for businesses, including the money from the EIB, comes to GBP 7 billion.

Reactions: "Could Do Better"

110. (U) The Shadow Chancellor, George Osborne, said the PBR highlight the deception in PM Brown's claim to have abolished boom and bust. He noted that the Chancellor announced the largest amount of borrowing ever undertaken by a British government. Osborne said

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HMG's decision to double the national debt to GBP 1 trillion is the bill for Labour's decade of irresponsibility, initiated by the Prime Minister. He said the Chancellor has created a "huge unexploded tax bombshell", timed to detonate underneath the future economic recovery. Osborne added that this is confirmation of the "time-old truth that in the end all Labour Chancellors run out of money and all Labour governments bring this country to the verge of bankruptcy." He concluded that this PBR is all about the political, not the economic, cycle as the tax rises, planned for 2011, do not come until after the next general election.

111. (SBU) If the Chancellor had a report card, it would be marked "could do better" by the Director General of the British Chambers of Commerce, David Frost. Frost said there are a few good announcements, including the deferment of the Small Business Rate of corporation tax and allowing businesses to spread out the payment of their tax bill, but he was very critical of the proposal to increase national insurance contributions. He said that while the economy should be coming out of recession, businesses will face an additional tax. David Kern, the BCC's Chief Economist, notes that while the PBR goes a long way towards acknowledging the UK is facing a serious recession, the forecasts are too optimistic. He expects growth in 2009 to be worse than predicted and is doubtful that positive quarterly GDP growth would start as early as mid-2009. Professor David Miles, Morgan Stanley's Chief UK Economist, is more optimistic about HMT's growth forecasts and said the short term

fiscal boost to the economy is substantial and will potentially generate a boost of 0.5 percent to 1 percent of GDP in 2009/10. However, Miles says the VAT cuts, while quick to implement, will likely not have as big a multiplier effect as other types of fiscal stimulus would have.

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